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TESI DI LAUREA

"Does the Busyness of Board of Statutory Auditors' Members Affect Financial Reporting Quality? Evidence from Italian Listed companies"

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Abstract

The objective of this thesis is to investigate the relationship between the busyness of the Board of Statutory Auditors' members and the financial reporting quality. Members of the Board of Statutory Auditors are allowed to hold multiple offices in different companies and this raises concern on whether or not this affects their monitoring duties. To address this discussion, this study analyzes a sample of 93 Italian publicly traded firms in 2018. The busyness of the Board of Statutory Auditors' members is based on their multiple directorships in different firms, while two distinct metrics for earnings management are used as proxy to financial reporting quality. The two metrics are the abnormal working capital accruals, estimated using the DeFond and Park Model (2001), and the discretionary accruals, estimated with the Modified Jones Model (Dechow et al. 1995). The effect will be examined by employing a multiple regression model controlling for firms' specific indicators. The data reveal that financial reporting quality is lower when the Board of Statutory Auditors' members are busier. Also, when those members hold multiple offices in other publicly traded companies, the impact is even more negative.

Summary

Introduction

The corporate structure of a firm, irrespectively of its industry, consists of different departments contributing to the realization of its overall mission and goals. The most common departments include Finance, Operations, Marketing, Human Resources and IT. These areas might be more or less interdependent, but they are linked together by one common thread, the Accounting & Finance division, which records, summarizes and reports to various stakeholders all the financial aspects of every department of the firm. Financial Statements are the final result and the main source of financial information for most decision makers, as they present the financial position of a firm at a point in time and its performance during a fiscal period. Their importance justify why financial reporting requires a high emphasis on the accuracy, the reliability and the relevance of the information included on Financial Statements.

In order to ensure a high level of accuracy and reliability of financial reporting, it is essential to have adequate and efficient internal controls. The term internal controls refers to all the rules, the policies and the procedures that a company can adopt to provide reliable financial reporting in compliance with local and international laws and regulations. One important element of the internal control system in Italian corporations is the Board of Statutory Auditors, which oversees the compliance with the law, the respect of the principles of correct administration, and the functioning of the administrative, organizational and accounting systems of the firm.

A correct and efficient oversight function is one key element to ensure a good level of quality in financial reporting: for this reason, corporate regulators all over the world provide strict rules on the individuals in charge of this particular function, both in terms of professional competences required and in terms of the total numbers of offices that they can hold in different companies during the same period. For example, in the Italian environment, CONSOB sets a limit on the cumulative offices for the Board of Statutory Auditors' members. Although prior literature does not agree on whether advantages or disadvantages of multiple directorships prevail, corporate regulators around the world often set a limit on the cumulative offices held by boards' members.
This study examines multiple directorships of the Board of Statutory Auditors. Being the Board of Statutory Auditors a control body of Italian companies only, this study analyzes only Italian listed

companies. After accounting for data availability, the final sample includes 93 companies among those that were listed at the end of the fiscal year 2018. The first research question that this study addresses is whether the multiple directorships of the Board of Statutory Auditors' members is associated with a lower effectiveness on their monitoring duties, as represented by a firm's financial reporting quality. In addition to examining the busyness of a firm's Board of Statutory Auditors, this study also aims at examining the impact of holding multiple roles in other publicly traded companies. The analyses are conducted in stages. First, the busyness of the Board of Statutory Auditors' members is analyzed at firm level, according to the numbers of offices held by each member of the Board. Then, two different metrics are adopted to measure financial reporting quality: abnormal working capital accruals (DeFond and Park model, 2001) and discretionary accruals (Modified Jones model, 1995). Finally, the relationship between the busyness of the members of the Board of Statutory Auditors and financial reporting quality is estimated through an ordinary least square regression.

This study enriches the literature on the busyness and financial reporting quality in multiple ways. First, it provides a country-specific context research by analyzing the Italian Board of Statutory Auditors and its relationship with the financial reporting quality. Second, by estimating two different proxies of earnings management, this study examines the explanatory power of both measurement instruments considered in the chosen models, the DeFond and Park model (2001) and the Modified Jones model (Dechow et al., 1995).

This thesis is composed of five chapters. Chapter 1 introduces the first main topic of the study, the Board of Statutory Auditors, by describing its importance, its role, its composition and its main functions. Chapter 2 summarizes the second relevant topic, the financial reporting quality, by reviewing the financial reporting structure and the attributes of quality. Chapter 3 introduces the discussion on boards' members' multiple directorships and reexamines prior literature on the relation between multiple directorships and financial reporting quality. It also describes the context of the study and illustrates the research hypotheses developed. Chapter 4 depicts the sample selection, the data gathered, the variables, and the estimation method implemented. Chapter 5 presents the results of the empirical analysis, discusses the findings obtained and introduces research limitations, as well suggestions for further researches.

Chapter 1: The Board of Statutory Auditors

This study aims to investigate the relation between the busyness of board's members and financial reporting quality, by focusing on the Board of Statutory Auditors in Italian listed firms. In order to examine this relationship, the busyness of the members of the Board of Statutory Auditors is calculated by looking at their numbers of multiple directorships held in different companies, while financial reporting quality is estimated using two metrics of earnings management. Chapter 1 introduces the Board of Statutory Auditors in the Italian system, by describing the role it has in the corporate governance structure of a company, as well as the importance, composition and main functions of this characteristic internal control body.

1.1 The role of corporate governance

Corporate governance refers to the system implemented to direct and control an organization, to align the interests of the directors of a company, the controlling and the minority shareholders, and all other stakeholders. Therefore, the corporate governance structure of an entity includes the rules, relations, processes and systems adopted to ensure an efficient and fair management of the enterprise (Cadbury, 1992). Throughout the years, corporate governance has become one of the most discussed issues in the business word. Enormous corporate failures, such as those of Enron, WorldCom, and Parmalat, required governments and regulatory authorities to strengthen the regulations in order to ensure the normal running of corporate organizations and prevent such failures (Al-Baidhani, 2014). Even though the objective of these regulations is the same, laws on corporate governance structures and committees may vary from country to country. This study focuses on a specific control body of the Italian environment only, the Board of Statutory Auditors (C*ollegio Sindacale*), therefore it is necessary to briefly discuss the corporate governance structures allowed for Italian joint stock companies to allow a better understanding of the context in which the Board of Statutory Auditors operates.

1.1.2 Corporate governance systems in Italian S.p.A.

Italian joint stock companies (*Società per Azioni*) can adopt three different types of corporate governance system for their management structure. The systems allowed by the Italian Civil Code are: the traditional system, the dualistic system, and the monistic system, and each of them requires the shareholders meeting to appoint different boards / bodies according to the governance structure in place. The first one, the traditional system (*sistema tradizionale*), requires the shareholders' meeting to appoint a management body which could be represented by a sole director or a Board of Directors, and that will be in charge of the management of the company. The shareholders' meeting appoints also a Board of Statutory Auditors (*collegio sindacale*), which is responsible for overseeing the company's compliance with the law and company by-laws, the respect of correct administration, and the adequacy and the actual functioning of the administrative, organizational and accounting systems of the firm, as stated in art. 2403 of the Italian Civil Code. The second corporate governance system, the dualistic system (*sistema dualistico*), is a two-tier system and it is regulated by art. 2409 of the Italian Civil Code. The shareholders' meeting is required to appoint a supervisory board (*consiglio di sorveglianza*) which then appoints a management board (*consiglio di gestione*). While the supervisory board is responsible for overseeing the company's compliance with the law, the management board is responsible for the company's day-by-day management. The third corporate governance system, called monistic system (*sistema monistico*), is a one-tier structure and it requires the shareholders' meeting to appoint a Board of Directors which is in charge of the management of the company. Among its members, the Board of Directors is required to appoint a control body (*comitato per il controllo sulla gestione*).

1.2 The Board of Statutory Auditors in the Italian system

The origins of the Board of Statutory Auditors as an internal control body is strictly related to the strategical objectives and procedures adopted by a firm when pursuing these goals. The most relevant among these targets are those to create profit and provide reliable information to insiders and outsiders of the firm. Having accurate and reliable information allows internally to adopt the most efficient and effective decisions for the success of the firm, and at the same it ensures a

transparent communication to all stakeholders about the effective value of the company in economic and financial terms. In addition to this, an important topic is that of compliance: all corporations must observe the norms and regulations adopted by the Italian legislation during the years within the legal and jurisdictional boundaries in which their activities are performed. It is clear that within this framework the firm does not have complete autonomy in the way in which it provides financial information to internal and external users. In this scenario takes place the origins and the functions of the Board of Statutory Auditors, an internal control body which helps controlling and overseeing the business activities.

1.2.1 The Board of Statutory Auditors as an internal control body

The Board of Statutory Auditors is considered an internal control body specific of Italian firms only (Rizzotti and Greco, 2012). It monitors the adequacy of the internal control systems, considering also the size and complexity of the company. An internal control system can be defined as the set of directives, procedures, and operating practices adopted by a corporation in order to achieve the following objectives:

- strategic objectives, aimed at ensuring the compliance of management's choices with the directives received and with the firm's mission, as well as guaranteeing the safeguard of the company's assets and protecting the interests of the stakeholders;
- operational objectives, aimed at ensuring the effectiveness and efficiency of the company's operating activities;
- reporting objectives, aimed at ensuring the reliability of the data;
- compliance objectives, aimed at ensuring the compliance of the company's activities with laws and regulations.

An efficient internal control system also facilitates a clear and precise analysis of the main business risk factors and improves the efficiency of monitoring management functions (Abbas and Iqbal, 2012). Therefore, as the Board of Statutory Auditors carries out most of these functions, it is commonly considered an internal control body (Cortesi et al., 2008).

1.2.2 Norms and regulations regarding the Board of Statutory Auditors

The norms and the regulations regarding the composition and the functions of the Board of Statutory Auditors in the Italian system have been constantly changing over time, since their first introduction in the 1970s. During these years, the role of the Board of Statutory Auditors has been subject to the continuous changes in the national and international economic environment. The structure of the Board of Statutory Auditors, its duties and responsibilities are defined by the Italian Civil Code. Such document states that its main activities consist in ensuring that the company acts in compliance with the law and the corporate statute, as well as protecting the adequacy of its organizational, administrative and financial structure. The Board of Statutory Auditors works alongside with the internal control system, ensuring that risks management takes place in compliance with the norms and regulations established by the Italian legislation. The legal principles are then translated into a set of ethical rules, which supports the entire legal audit activity carried out by the Board of Statutory Auditors. These fundamental principles could be summarized in independence, integrity, objectivity, competence, diligence, and professionality.

According to the Italian Civil Code, the Board of Statutory Auditors is always mandatory for joint stock companies (*S.p.A., Società per Azioni*) and for partnerships limited by shares (*S.a.p.A., Società in accomandita per Azioni*). For limited liability companies (*S.r.l., Società a responsabilità limitata*), pursuant to art. 2477 of the Civil Code, the Board is mandatory only if at least one of the following situations occurs: the company cannot prepare the Financial Statements in the abbreviated form because it exceeds the limits set by the Civil Code, the company is obliged to prepare the consolidated Financial Statements, or the company controls at least one company obliged to perform a statutory audit. In other cases, the Board of Statutory Auditors is optional and it can be required by the Constitution of the company.

1.2.3 Composition of the Board of Statutory Auditors

According to art. 2397 of the Italian Civil Code, the Board of Statutory Auditors is composed by three or five standing auditors plus two additional alternate auditors. The members of the Board of Statutory Auditors are appointed by the shareholders' meeting and the term of office of Statutory

Auditors is mandatorily established for three financial years. Also, it is possible that the government or other public entities arrange the nomination of the Statutory Auditors. In the event of revocation or resignation of a standing Auditor, an alternate takes over in order of seniority, while the shareholders' meeting appoints the new Auditor until the established number is restored. However, the new Statutory Auditor will remain in office only until the end of the mandate.

Art. 2399 of the Italian Civil Code lists a number of causes of incompatibility with the Board of Statutory Auditors, including relationships of kinship up to the fourth degree, and affinity with the directors of the company, with the parent and subsidiary companies, as well as with business and work relationships with the same companies. When these situations arise after the nomination of the Statutory Auditors, they automatically determine the dismissal of that or those members. In addition to the limitations and causes of incompatibility provided by the Italian Civil Code, each firm's Statute may add further restrictions.

The professional requirements are also extremely important. Art. 2937 of the Italian Civil Code establishes that Statutory Auditors can also be shareholders of the company; it also sets subjective and professional limits. At least one of the standing Auditors and one alternate must be registered in the Register of Certified Auditors and the remaining members who are not registered must be chosen among lawyers, chartered accountants, commercial experts, labor consultants, or university professors in economic and legal matters.

1.2.4 The functions of the Board of Statutory Auditors

The Board of Statutory Auditors is considered an internal control body within the company's governance system and it is in charge of the control of legitimacy and legality of the direction. Specifically, as indicated in art. 2403 of the Italian Civil Code, the Board of Statutory Auditors oversees the compliance with the law and with the firm's by-laws, the respect of the principles of correct administration, and the adequacy and the actual functioning of the administrative, organizational and accounting systems of the corporation. First, the function related to the oversight of the compliance refers to the correct application of the legal and regulatory provisions in force and of any other norm contained in the company by-laws. In fact, the Board of Statutory Auditors, in the exercise of its activities, is responsible for ensuring and verifying the compliance

of the corporate bodies with the law. Second, the oversight of the respect of the principle of correct administration refers to verification that the firm's directors' decisions are compliant with the criteria of economic rationality established by the science of corporate economics. Therefore, the Board of Statutory Auditors ensures that directors perform the necessary diligence in fulfilling their duties; however, it does not control and judge the directors' economic decisions, but it only examines their legitimacy. Third, the Board of Statutory Auditors verifies that the adequacy and the functioning of the firm's administrative, organizational and accounting systems are adequate for the nature and for the size of the firm, as well as for its type of business activities. This type of control on the directives and procedures adopted by the company aims at safeguarding the efficient conduct of the business and its order and transparency.

Chapter 2: The importance of financial reporting quality

This chapter introduces the concept of financial reporting quality. The first part briefly reviews the structure of financial reporting and emphasizes the importance and the purpose of Financial Statements. The second part defines the concept of quality and presents its attributes, illustrating the fundamental and enhancing qualitative characteristics that financial reports must possess to ensure a high level of quality.

2.1 Structure of financial reporting

Financial Statements, or Financial Reports, are written records of the financial activities of a company and its financial performance. They represent the enterprise's financial position at the end of a fiscal year and the economic result for that period (operating income) in order to monitor its performance over time. In addition, they also constitute the starting point for calculating taxation. In the Italian context, publicly traded companies are required to adopt International Accounting Standards (IAS) or International Financial Reporting Standards (IFRS) which are sets of globally accepted accounting standards. IAS 1 states that a firm's Financial Statement should be composed of five different documents: the Statement of Financial Position, the Statement of Comprehensive Income, the Statement of Cash Flows, the Statement of Changes in Equity and a set of Notes to the Financial Statements. The Statement of Financial Position of a company, also called Balance Sheet, at the end of a fiscal period includes the firm's assets, liabilities and shareholders' equity at that specific point in time. The Statement of Comprehensive Income, or Income Statement, or Profit and Loss report, illustrates the economic result of the management for a given fiscal period, by analyzing the revenues and the costs incurred during that time. The Statement of Changes in Equity shows the total comprehensive income for the period, the effects of retrospective applications for each component, and the reconciliation between the amounts at the beginning of the year and at the end of the year for each component of the equity. The firm's Cash Flow Statement summarizes all the cash flows that occurred in a given period. This document shows all the sources that contributed to increase or decrease the liquidity available for a company

in that timeframe. Finally, the Notes to the Financial Statement typically describe in detail some of the most relevant items of the Balance Sheet and Income Statement.

2.1.1 Purpose of Financial Statements

According to the Framework for the Preparation and Presentation of Financial Statements (IASB, 2007), the ultimate goal of a firm's Financial Statements is to provide useful information on the financial position, the economic result and the changes in the financial structure of a company to a wide range of users who make decisions based on those results. Specifically, users can deploy Financial Statements for different purposes, for example:

- the management of a firm requires reliable Financial Statements to make the best business decisions regarding the continued operations. Moreover, the financial analysis that is performed on the Financial Statements provides management with an even more detailed description of the figures;
- Financial Statements are used by investors as a basis for their investment decisions. An entity's Financial Statements are at the basis of all valuation models and are systematically analyzed by investors and financial analysts in order to estimate the current market value of a firm;
- banks and other lending companies use companies' Financial Statements to decide whether to grant them new funds or to extend debt securities. Moreover, the amount of funds that financial institutions are willing to lend is strictly related to the financial position of firms.

Financial Statements' users are not limited to the ones mentioned above: also employees, suppliers, customers, and other subjects are interested in the financial position of a certain firm for a variety of reasons. As many of these users base their decisions on companies' Financial Statements, having reliable and faithful figures constitutes one of the most important elements required. The usefulness and precision of financial data are commonly referred to as the quality of the financial reporting.

2.2 The financial reporting quality

IFRS (International Financial Reporting Standards) define a standardized set of rules and principles that companies must follow when preparing Financial Statements in countries where these accounting standards are adopted. In this way, they ensure uniformity in the financial reporting of all businesses adopting IFRS, allowing companies' Financial Statements to be better understood and compared across international boundaries. Following IAS 1, which sets out the overall requirements for Financial Statements, a firm's Financial Statement must depict detailed information about the economic performance of that company, as highlighted in the Income Statement, its financial position, its cash flows and its changes in equity. IFRS state that any firm's Financial Statements are expected to have the required qualitative attributes such as relevance, comparability, timeliness, understandability, faithful representation and verifiability. These requirements ensure that the information provided is of high quality.

Financial reporting quality could be defined as the exact manner in which information regarding a business activity and its anticipated cash flows are shown, with the aim of informing the shareholders about a company's operations (Verdi, 2006). According to Tang, Chen & Zhijun (2008), financial reporting quality refers not only to the manner in which financial information is provided, but also to the degree of fairness and accuracy of the information reported. From these two definitions, it can be deducted that for Financial Statements to possess high quality information, and therefore to provide shareholders and all stakeholders with punctual and reliable information about the firm's current situation, they must be able to provide authentic information on the economic performance, the financial position and the cash flows resulting from operations. Financial reporting quality could also be defined as the faithfulness of information gathered in the financial reporting process (Martinez Ferrero et al., 2015). Following the definition from Martinez Ferrero et al. (2015), which focuses mainly on the financial aspect of corporate information, Aifuwa and Embele (2019) further expand and modify their definition by describing financial reporting quality as the faithfulness of information gathered in both the financial and non-financial reporting processes. Therefore, it is mandatory that companies' financial reports have high quality information in order to increase the confidence of users.

The next step is to assess how financial reporting quality can be observed and therefore it is necessary to analyze both the fundamental and enhancing qualitative characteristics for assessing the quality of the financial reporting defined by the International Accounting Standard Board, and the concept of earnings quality.

2.2.1 Attributes of quality

According to IASB, the faithfulness of the objectives and the quality of the information disclosed in a firm's financial report is one of the fundamental principles to assess financial reporting quality, because one of its main goals is to present transparent information to stakeholders, which can be achieved only if high quality is pursued. The Conceptual Framework for financial reporting approved by IASB in 2010 sets a list of elements for high quality financial reporting, explaining that, to achieve a high level of quality, financial reports must possess both fundamental qualitative characteristics and enhancing qualitative characteristics. The former include relevance and faithful representation, while the latter comprise verifiability, comparability, understandability and timeliness.

Relevance

Relevance is the first fundamental qualitative characteristic and it is often associated to the terms materiality and usefulness (Herath and Albarqi, 2017). The term materiality relates to the capability of affecting the decisions made by users in their capacity as capital providers; the term usefulness underlines the fact that useful information facilitates users to evaluate, correct and confirm past and current events. Beest, Braam and Boelens (2009) sustain that one of the highly significant indicators of relevance is the fair value, arguing that if an entity uses fair value as a basis for measurement, this is an indicator of high level of relevance in that firm's financial reporting information. Another important element that influences the level of relevance is the annual reports' disclosure of forward looking information about the risks and the business opportunities, and the feedback provided on how the company has been affected by major market events (Beest, Braam and Boelens, 2009).

Faithful Representation

Another qualitative characteristic that should be reflected in financial reports is the faithfulness of the information. The Conceptual Framework of Financial Reporting (IASB, 2010) gives a clear definition for the concept of faithfulness representation: a firm's Financial Statements must reflect and represent to the maximum extent possible neutral, complete and free from error financial information. Faithful representation of the financials of a company is at the basis of the usefulness of the Financial Statements (Herath and Albarqi, 20173); therefore, it is expected that financial reports should provide reliable representation of the economic situation of the entity, and nothing else.

Verifiability

Verifiability is one of the four enhancing qualitative characteristics for financial reporting defined by the Conceptual Framework (IASB, 2010). Financial information is classified as verifiable when it faithfully represents the economic situation of a business. In particular, it should be possible for independent observers to reproduce exactly the same financial results given the same facts and assumptions. For example, external auditors of a firm, considering the same set of financial records used by the company, should be able to build the same Financial Statements results. Another important element needed to achieve verifiability is the knowledge of the assumptions implemented by a business in constructing its Financial Statements. For example, the calculation of the depreciation expenses by a third party could easily vary from the expenses estimated by a company, as it relies on the projected useful life and salvage value of the assets. To sum up, verifiable Financial Statements assure their users that they fairly represent the business transactions of that entity.

Comparability

Comparability refers to the concept of allowing users to compare Financial Statements across time and among different companies in the same period. According to Cheung et al. (2010), comparability is possible only if identical events are reflected by identical accounting facts and figures in different Financial Statements. To preserve the comparison among different Financial Statements, any changes in the accounting policies and any implications resulting from these

changes should be disclosed and explained in the Notes at the end of the financial reports. Beest, Braam and Boelens (2009) sustain that providing financial index numbers and ratios in a firm's Financial Statement helps the comparison with other organizations.

Understandability

Understandability is another essential element of quality of financial reporting. It refers to the concept that financial information should be easily comprehended by users who have a reasonable knowledge of business and economic activities (The Conceptual Framework for Financial Reporting, 2010). According to Cheung et al. (2010), this can only be achieved through effective communication of the financial data: information that is clearly and sufficiently presented and classified results in a higher quality.

Timeliness

The last enhancing qualitative characteristic of financial reporting is timeliness. Herath and Albarqi (2017) explain that financial information must be available before it loses its usefulness to decision makers. In fact, according to Almosa et al. (2007), timeliness in financial reporting is considered vital and a significant factor influencing the usefulness of the financial information available to external users. Moreover, timely financial reporting is not only necessary for a decision maker, but also for a healthy financial market. An efficient and timely allocation of the resources could be achieved by reducing the asymmetry of information (Kamran, 2003). To summarize, all prior literatures agrees on the fact that there is a negative relationship between the value of the information reported in the Financial Statements and its timeliness (Mc Gee et al., 2013).

2.2.2 Earnings quality

As introduced before, users of Financial Statements are always pursuing high quality financial information and this could derive from a high level of earnings quality, which is also known as one of the most relevant indicators of capital market efficiency (Herath and Albarqi, 2017). Even though the meaning of earnings quality seems to be very straightforward, as it refers to the quality

of the earnings reported in a firm's Financial Statements, the concept behind this term has been at the center of accountants' discussions for many years. It is clear that earnings quality is a very important concept; however, there are many definitions and none of them is universally accepted (Holt, 2013). For example, Knechel et al. (2007) defines earnings quality as the reasonableness of reported earnings, while Den Besten et al. (2015) refers to earnings quality as the ability of the reported earnings to predict a firm's future earnings. There is no unanimous agreement also on the metrics adopted to proxy earnings quality: prior literature adopted different metrics, such as abnormal accruals and accruals quality, timeliness, smoothness, predictability, persistence and earning variability (Ewert and Wagenhofer, 2011). One concept on earnings quality is undebated: a high level of accuracy and precision should result in high accounting quality (Herath and Albarqi, 2017).

2.2.3 Financial reporting quality vs earnings quality

Even though the concepts of financial reporting quality and earnings quality are substantially different, they are still tightly connected and, in the context of earnings management, the two concepts are used as substitutes (Herath and Albarqi, 2017).

Table 2.1 in the next page shows the proxies used in prior literature to measure the financial reporting quality versus the ones of the reported outcome indicated by the CFA (Chartered Financial Analyst) Institute, a non-profit global organization of investment professionals that offers a wide range of programs and professional training to set a high set of standards for investment professionals. As stated by the CFA Institute, the proxies for financial reporting quality represent the reliability of the financial data, while the proxies for earnings quality refer directly to the substantial performance of the firm.

Table 2.1

Financial reporting quality vs reported outcome quality

Financial Reporting Quality	Quality of Reported Outcome
- Decision – useful information - Faithful representation of economic reality - Compliance with standards	- Sustainable activity - Adequate returns - Higher company's value

Source: CFA Institute

Moreover, it can be easily proved that these two concepts are complementary, since a minimum level of financial reporting quality is required to correctly assess the earnings quality and an improvement on the level of the reporting quality will allow financial reporting's users to easily assess the earnings quality. The relation between these two concepts can be summarized in the table below.

Table 2.2

The relation between financial reporting and earnings quality

		Financial Reporting Quality	
		Low	High
Earnings Quality	Low	LOW financial reporting quality impedes assessment of earnings quality and valuation	HIGH financial reporting quality enables assessment LOW earnings quality decreases company value
	High	HIGH earnings quality increases company value	HIGH financial reporting quality enables assessment of earnings quality and valuation

Source: CFA Institute

Clearly, there is a positive correlation between financial reporting quality and earnings quality. In fact, poor earnings quality is often the reason behind a poor financial reporting quality.

Chapter 3: Literature review, context and hypothesis development

The previous chapters illustrated the two main topics of this study, the Board of Statutory Auditors and the financial reporting quality. This chapter first introduces the problem of boards' members' multiple directorships, then it reviews prior academic literature on this topic and its relationships with financial reporting quality. Furthermore, some information will be provided about the context of this research, the Italian environment, by illustrating specific CONSOB regulations regarding multiple directorships of the members of the Board of Statutory Auditors in Italian listed firms. Finally, the hypotheses tested will be explained in detail in the final part of the chapter.

3.1 An overview on the problem of multiple directorships

After introducing the Board of Statutory Auditors and its main characteristics and analyzing the concept of financial reporting quality, it is necessary to address another topic in order to fully understand the objective of this study. The corporate governance consequence of multiple directorships represents a widely discussed issue worldwide, both in the business and in the academic environments. Several institutions and shareholder groups expressed concern that busyness could result in boards' members who are too busy to perform their monitoring functions effectively (Zheng, 2008). For example, in the United States, the National Association of Corporate Directors guidelines (NACD 1996) advise that senior corporate executives and CEOs should not hold more than three offices in outside companies, and the Council of Institutional Investors (CII 1998) recommends that board members should serve at maximum on three different boards. Similarly, in the UK the Combined Code (2004) sets a limit on the numbers of offices for executives and non-executives directorships. In the Italian context, CONSOB, with "Regolamento Emittenti", limits the number of offices that board members can hold. In contrast, some companies supported the multiple directorships of their board members, because it helps improving governance effectiveness. For example, in 2004 Brown Forman, one of the largest American owned company in the wine business, wrote in their annual report that the fact that one member of the audit committee was holding more than three roles in other companies enhanced his ability in his tasks.

There is also a widely discussed academic debate on the consequences of multiple directorships. Prior researches provide contrasting ideas on the effects of the busyness of corporate boards' members. On one hand, following an agency theory perspective, some researchers argue that boards with a high level of busyness are associated with ineffective monitoring due to insufficient time and effort committed (e.g. Fich and Shivdasani, 2006 and Shivdasani and Yermack, 1999). On the other hand, others sustain that multiple directorships of board members are beneficial to shareholders (e.g. Fama and Jensen, 1983 and Vafeas, 2005). Based on a labor market perspective, board members with multiple offices tend to be more diligent in performing their duties, because of a larger human capital at stake. Moreover, holding offices in different companies adds valuable experiences and increases their knowledge. Therefore, the effect of multiple directorships on the board's governance effectiveness has not reached a consensus, as both advantages and disadvantages are recognized.

3.1.1 Competences vs busyness

There are many characteristics of the members of the Board of Statutory Auditors that could affect their work effectiveness. In fact, prior literature contains plenty of studies analyzing the effect of those characteristics on the financial reporting quality. There is no doubt that members of the Board of Statutory Auditors possess the competences requested in order to succeed in their role of supervision. This is because, as mentioned before, for an individual to be appointed as a Statutory Auditor, he / she must fulfill certain professional requirements set by the Italian Civil Code, as for example being registered to the Register of Certified Auditors or other professional Register or being a university professor of economics or law. However, many studies addressed the issue on the relation of the financial reporting quality with the competences of the directors and the Audit Committees' members, such as their financial expertise, their tenure, etc. The main purpose of all these studies was not to discuss whether these figures possess enough competences, but they aimed at analyzing whether a higher level of competences reflects in a higher financial reporting quality. In addition to the individual competences, the busyness of the members has been at the center of several studies. Specifically, many researchers investigated whether the multiple directorships of the Audit Committee's members could affect their ability. However, as it will be widely illustrated

in the next chapter, there is no unanimous decision on the effect of busyness on financial reporting quality. Several studies support the idea that holding multiple directorships may reduce the work effectiveness of the board members; on the contrary, other studies sustain that holding offices in different companies enhances board members' ability and knowledge.

3.2 Literature review

Due to the novelty of this study, which focuses on the members of a specific internal control body of Italian firms only, namely the Board of Statutory Auditors, it is not possible to find prior studies with the same exact interests. Nevertheless, prior literature provides various researches that analyze the busyness of directors and of Audit Committees' members, and their relation with firm performance and financial reporting quality. As per Rizzotti and Greco (2012), in the Italian corporate governance system there is no Audit Committee; however, some of its functions are carried out by the Board of Statutory Auditors. Therefore, for the sake of this study, it is reasonable to look at previous researches regarding multiple directorships and the Audit Committee, because of its similarity with the Italian Board of Statutory Auditors.

The final goal for both bodies is to ensure that companies provide transparent and reliable information to outsiders. Internationally, the Audit Committee's role is to assist the Board of Directors to satisfy its corporate governance and overseeing responsibility related to the firm's financial reporting, risk management system, internal control system and internal and external audit functions. Specific norms and requirements for the Audit Committee vary country by country; however, there are some universalities for Audit Committees across different governance structures. Specifically, the European Union, national legislations and national governance codes often define legal requirements for boards and Audit Committees which are mandatory (EY, European Corporate Governance 2019). For example, these requirements could regulate board members' independence, their multiple directorships in different companies or set academic and professional requirements for auditors. While these specific requirements, the responsibilities of the Audit Committees and how they work could vary among different countries, some functions can be considered as the standard role of an Audit Committee, regardless of the structure. Such general functions refer to: supervising internal controls and risk management process, managing

the external audit process and monitoring company accounts to oversee the financial reporting process.

3.2.1 Directors' busyness and firm value

Notwithstanding the fact that this study looks at the relation between busyness and financial reporting quality, it is important to briefly discuss the contexts of prior researches related to the busyness of directors and members of a firm. Many of these works looked at the busyness of directors and firm value.

The problem with holding multiple board seats has been at the center of academic research for a long time, expanding from the empirical evidence on the reasons of multiple directorships (O'Sullivan et al. 2005; O'Sullivan et al., 2009) to the consequences of such busyness on various financial matters (Fich and Shivdasani, 2006). Overall, the documentation on the relation between the busyness of boards' directors and the firm value offers different perspectives and findings. Fama and Jensen (1983) showed that directors' ability is compensated with additional board appointments. Supporting this idea, Ferris et al. (2003) proved that the directors whose firms perform better are more likely to participate to more board seats in the future. Similarly, Ferris et al. (2003), as well as Brown and Maloney (1999), demonstrated that there is a positive correlation between directors with multiple board seats and stock returns. Therefore, these results advocate a positive relation between the busyness of directors and firms' performance.

On the contrary, other researchers suggested that holding multiple board seats reduces the ability of the directors of advising and monitoring the firms efficiently. Fich and Shivdasani (2006) found that firms where the majority of outside directors hold multiple roles in different companies are associated with weaker corporate governance and worse performance. Another study of the same authors also documented a positive announcement return whenever a busy director leaves the board.

Overall, whether a busy board may improve the performance of the firm or worsen its effectiveness remains an open question for debate. Both views have empirical support in the literature and are intuitively appealing. Moreover, Cashman (2012), after analyzing previous literature with the aim

of understanding to what are attributable such differences in the results, found that the inclusion or exclusion of smaller firms in the sample impacts the inferences drawn regarding busy directors.

3.2.2 Audit Committee busyness and financial reporting quality

The relationship between the characteristics of an Audit Committee, such as its independence and financial expertise, and financial reporting quality has been at the core of academic research for a few decades (e.g. Fama and Jensen, 1983, Yang and Krishnan, 2005, and Tanyi et al., 2015). Moreover, in recent years, it has become more and more important to examine other aspects of boards' members and internal committees, such as the busyness of these members, with particular attention to multiple directorships in other offices and the relationship with the quality of the financial reporting.

According to Uniamikogbo et al. (2014), two fundamental existing theories support the idea that Audit Committee's multiple directorship can affect financial reporting quality. On one hand, agency theory suggests that members of the Audit Committee with a high level of busyness might be subject to time constraints and work overload, which could adversely affect the financial reporting quality of the firm audited. On the other hand, labor market theory implies that Audit Committee members with a high level of busyness might work in a more diligent way, thanks to their reputation and their willingness to share their experience and knowledge, which increases firm performance and financial reporting quality.

A significant number of studies show the benefits deriving from holding additional directorships. Fama and Jensen (1983) noted that the reputation of directors as efficient monitors for a firm increases with additional directorship, thus supporting the idea that busy directors may be more capable than their counterparts. Yang and Krishnan (2005) showed that earnings management seems lower for firms whose Audit Committee's directors hold multiple board seats.

On the contrary, several studies do not support the beneficial impact of additional directorships on earnings quality, arguing that board monitoring requires substantial time and effort (Beasley, 1996). Miwa et al. (2000) also found a strong negative relationship between multiple directorships of the Boards' members and financial reporting quality. Contrarily to Yang and Krishnan (2005),

Dhaliwal et al. (2010) found that members of Audit Committees with higher directorships are associated with more earnings management. Furthermore, other studies demonstrated the existence significant relations between the Chairman of the Audit Committee and financial reporting quality. Zheng (2008) did not find a positive relation between multiple directorships of the Audit Committee as a whole and financial reporting quality; however, he proved that the multiple directorships of the Chairmen are significantly positively associated with financial reporting quality. On the opposite, Tanyi et al. (2015), in investigating how the number of Audit Committee Chair positions held by the Chairman affects financial reporting quality, found that there is a negative relation between the number of such leadership positions held by the Chairman and the firms' financial reporting quality.

Overall, prior literature does not provide univocal support to either of the two theories: it is still uncertain whether busyness helps improving directors' efficiency and accuracy or it is detrimental. Therefore, given the different positions, this study seeks to further examine the effects of the busyness on financial reporting quality by looking at the relationship between multiple directorships of the members of the Board of Statutory Auditors in Italian listed firms and financial reporting quality.

3.2.3 Regulating multiple directorships

The problem with holding multiple board seats is not only at the center of academic research, but it is also a major concern for corporate governance regulators. A common view among these institutional bodies is that holding multiple board seats can result in over-stretched directors reducing their ability of monitoring and advising the firms effectively. In Italy, "Regolamento Emittenti" by CONSOB regulates and limits the number of offices that any member of any internal control body can hold. Similarly, in the UK and in the USA, the Combined Code (2003) and the National Association of Corporate Directors (1994) respectively provide guidelines and suggestions on the number of executives and non-executives directorships that could be held in other listed companies. Although in recent years these types of regulations have increased in

general, the holding of various directorships by non-executive board members is still highly unregulated around the world (Ghafran, 2013).

3.3 Context of Analysis

The sample of companies in this study includes only Italian listed firms and considers an internal control body typical of the Italian environment only, the Board of Statutory Auditors. Therefore, it is necessary to review the regulations regarding the offices held by the members of this Board before going into the details of the research.

3.3.1 The role of CONSOB

CONSOB (*Commissione Nazionale per le Società e la Borsa*), the National Commission for Companies and the Stock Exchange, is the Italian body regulating and overseeing investors' protection, efficiency, transparency and development of the Italian securities market. It is an independent administrative authority with independent legal capacity and full operational autonomy, established with the law of June 7th, 1974, nr. 216. CONSOB carries out many different functions. The most important could be summarized as follow:

- regulate the provision of investment services, the disclosure obligations of listed companies and the public offerings of financial products;
- authorize the publication of prospectuses relating to public sale offers and offer documents relating to public purchase offers, the exercise of regulated markets, and registration in the sector registers;
- oversee market management companies' operations and transparency, and orderly conduct of negotiations;
- penalize supervised entities if necessary, directly or by making a proposal to the Ministry of Economy and Finance;
- check the information provided to the market by listed companies and by those who promote offers of financial instruments to the public, as well as the information contained in the financial documents of listed companies;

- ascertain any anomalous trends in trading of listed securities and perform any other act of verification of violations of the rules on market manipulation, abuse of privileged information (insider trading) and manipulation.

3.3.2 The "*Regolamento Emittenti*"

The Issuers' Regulation (*Regolamento Emittenti*), which was introduced in May 14th, 1999, contains all the regulations aimed to direct the discipline of the issuers.

The Regulation is divided into four parts: the first one is dedicated to regulatory sources and additions. The second part, called "Appeal to Public Savings", regulates the public offer and trade for subscription (*Offerta Pubblica di Sottoscrizione*) of financial instruments and the public purchase offer or exchange (*Offerta Pubblica di Acquisto and Offerta Pubblica di Scambio*). The third section, called "Issuers", regulates multiple aspects: the admission to trading on regulated markets of European financial instruments and units or shares of collective investment savings bodies, corporate information, ownership structures, uses of voting rights, the protection of minorities, the administration and control bodies, the audit, and finally the subjects who have access to privileged information. The fourth and last part is related to transitional and final provisions.

The Issuers Regulation also includes eight attachments:

(i) Annex 1 - Offer to the public for the subscription and / or sale of financial instruments and admission to trading community financial instruments

(ii) Annex 2 - Public purchase and / or exchange offers

(iii) Annex 3 - Company information

(iv) Annex 4 - Ownership structures

(v) Annex 5 - Delegation of voting rights

(vi) Annex 5-bis - Calculation of the limit on the accumulation of offices

(vii) Annex 5-ter - Audit engagements

(viii) Annex 6 - Communication to CONSOB and public disclosure of information

3.3.3 CONSOB regulations on board members' multiple directorships

Some articles of "Regolamento Emittenti" are strictly connected with this study because they are related to the limitations to the cumulation of offices by the members of any control body, therefore also of the Board of Statutory Auditors. For example, as anticipated in the above paragraph, CONSOB establishes a limit on the cumulations of offices estimated with a particular weighting system, and it also establishes all the information that board members are required to immediately communicate to CONSOB.

Art. 144 – terdecies: limits on the cumulation of offices

The first article somehow connected to this research is art. 144 – terdecies. This article helps regulating the limits on the cumulative positions held by the members of internal control bodies. In general, if a member holds the same position in five different issuers, he / she cannot hold the same position in any additional issuer. Moreover, the total number of administrative or control positions that a member of the control body of an issuer can hold must be less or equal to a limit corresponding to six points resulting from the application of the calculation model showed in Table 3.2, reported in the next page.

Table 3.2

CONSOB weighting system

3. Plurality of office calculation model

	Type of office by company category	Weighting	No. of offices held	Score	
ISSUERS	Issuer - Member of the internal control body	1		0,00	Limit to the no. of offices ≤ 5
	Issuer – Director with delegated management powers	2		0,00	
	Issuer – Director without delegated management powers but an executive committee member	1		0,00	
	Issuer – Director without delegated management powers and not an executive committee member	0,75		0,00	
PUBLIC INTEREST COMPANY	Public interest company – Member of the internal control body	0,75		0,00	
	Public interest company – Member of a subsidiary's internal control body	0,45		0,00	
	Public interest company – Director with delegated management powers	2		0,00	
	Public interest company – Director with delegated management powers in a subsidiary (1)	1,2		0,00	
	Public interest company – Director without delegated management powers but an executive committee member	0,75		0,00	
	Public interest company – Director without delegated management powers but an executive committee member of a subsidiary (1)	0,45		0,00	
	Public interest company – Director without delegated management powers and not an executive committee member	0,6		0,00	
	Public interest company – Director without delegated management powers and not an executive committee member of a subsidiary (1)	0,36		0,00	
UNLISTED COMPANIES AND COMPANIES NOT ISSUERS OF WIDELY-DISTRIBUTED SECURITIES	Large – Statutory auditor with accounting control	0,6		0,00	Medium-sized companies
	Large – Statutory auditor with accounting control of a subsidiary	0,36		0,00	
	Large - Member of the internal control body	0,4		0,00	
	Large - Member of a subsidiary's internal control body	0,24		0,00	
	Large – Director with delegated management powers	1		0,00	
	Large – Director with delegated management powers in a subsidiary (1)	0,6		0,00	
	Large – Director without delegated management powers but an executive committee member	0,4		0,00	
	Large – Director without delegated management powers and an executive committee member of a subsidiary (1)	0,24		0,00	
	Large – Director without delegated management powers and not an executive committee member	0,3		0,00	
	Large – Director without delegated management powers and not an executive committee member of a subsidiary (1)	0,18		0,00	
	Medium – Statutory auditor with accounting control	0,4		0,00	Medium-sized companies
	Medium – Statutory auditor with accounting control of a subsidiary	0,2		0,00	
	Medium - Member of the internal control body or Director	0,2		0,00	
	Medium - Member of the internal control body or Director of a subsidiary (1)	0,1		0,00	
	Small - Member of the internal control body or Director	0		------	Small businesses
				0,00	Score limit ≤ 6

Source: CONSOB Annex 5-bis, Model 1

In this table, the column "Weighting" indicates the individual value of each role, measured by considering the time commitment required for that role, the type of role per se, and the characteristics of the company in which that role is held. The reason for attributing different weights for different type of firms, i.e. listed versus not listed, is based on the fact that different types of roles held in different kinds of companies require more or less time commitment.

Art. 144 – quaterdecies: disclosure obligation to CONSOB

Art. 144 – quaterdecies defines all the information that CONSOB requires in terms of offices held by the members of an internal control body. In general, every director or member who holds the office of member of control body in more than one issuer shall inform CONSOB with any relevant change in current offices or changes in their personal details, including the size of the company in which the office is held. As a consequence, CONSOB always possesses the current information about members of the Board of Statutory Auditors.

Art. 144 – quinquiesdecies: public disclosure of the information

Art. 144 – quinquiesdecies states that CONSOB must publish on its website all the latest information acquired following to Art. 144 – quaterdecies, on behalf of the members of the supervisory bodies of companies. This specific article of the CONSOB regulations allowed to retrieve all the information required by this study regarding the numbers and the types of offices held by the members of the Board of Statutory Auditors of the firms in the sample.

3.4 Hypotheses development and discussion

This thesis examines the relationship between multiple directorships of Board of Statutory Auditors' members and financial reporting quality. The research includes in total three different hypotheses. In doing so, an analysis of multiple directorships at the Board of Statutory Auditors

level for each firm included in the sample has been performed. The first hypothesis investigates the relationship between multiple directorships of the Board of Statutory Auditors and financial reporting quality. The second and third hypotheses focus on the roles held in other listed companies only: the second one analyzes the effect of holding two or more roles in listed companies and financial reporting quality; the third one examines the effect on financial reporting quality of Board of Statutory Auditors' Chairmen, when they hold two or more offices in other listed companies.

3.4.1. The effect of Board of Statutory Auditors members' multiple directorships on financial reporting quality

As discussed in the previous chapter, the Board of Statutory Auditors oversees the compliance with the law, the respect of the principles of correct administration, and the adequacy and the actual functioning of the administrative, organizational and accounting systems of the firm (art. 2403 of the Italian Civil Code). Costs and benefits deriving from multiple directorships do not lead to a unanimous opinion in the literature on whether there is a positive or negative effect of multiple directorships and financial reporting quality. A Board of Statutory Auditors' member with numerous offices in other companies might contribute to its effective functioning as he / she might bring more experience (knowledge transfer effect) and has stronger incentives to monitor because of his / her higher reputational capital at stake (labor market effect). On the other hand, a Board of Statutory Auditors' member with several offices in other companies might be overcommitted and therefore contributes less time and effort to its service in each firm, negatively affecting financial reporting quality. This study, following Lopez and Peters (2012), hypothesizes that financial reporting quality is lower when members in charge of overseeing financial reporting hold several offices in different firms. Consequently, the expectation is a negative relationship between the busyness of the Board of Statutory Auditors' members and financial reporting quality. The first hypothesis that will be tested is:

Hypothesis 1: The higher the number of roles held by members of the Board of Statutory Auditors, the lower the firm's financial reporting quality.

3.4.2. The impact of holding multiple roles in publicly traded firms

While the first hypothesis analyzes the effect of multiple directorships of the Board of Statutory Auditors' members on financial reporting quality, assuming that all offices require the same level of attention and time commitment, the second hypothesis of this thesis focuses on the members who hold multiple offices in publicly traded firms. As mentioned in the previous section of this chapter, art. 144 – terdecies of CONSOB regulation establishes for Italian companies a limit on the cumulative positions held by the members of internal control bodies. The total number of administrative or control positions that a member of the control body of an issuer can hold must be less or equal to a limit corresponding to six points resulting from the application of the calculation model showed in the Annex 5-bis, Model 1 (page 34). In this model CONSOB differentiates the roles held in public firms from the roles held in private firms, as well as those held in large – medium companies and small ones, by assigning a "weight" to each role depending on the characteristics of the entity where the role is held. Following the same reasoning, this study analyzes the effect of the Board of Statutory Auditors' members who hold multiple roles in publicly traded firms versus those who do not. The second hypothesis that will be tested is:

Hypothesis 2: If two or more members of the Board of Statutory Auditors hold two or more roles in listed companies, the firm's financial reporting quality is lower.

3.4.3. The impact of Chairman's multiple directorships in publicly traded firms

The third and last hypothesis that will be tested in this research focuses on the multiple directorships of Chairmen of the Board of Statutory Auditors. Tanyi and Smith (2015) investigated how the number of Audit Committee Chair positions held by the Chairman affects financial reporting quality. They found that there is a negative relation between the two. However, this thesis does not focus on the total number of offices held by the Board of Statutory Auditors' Chairmen; instead, following the logic behind the second hypothesis, it investigates the possible effect on financial reporting quality of the multiple directorships of Chairmen in listed firms only. The third hypothesis that will be tested is the following:

Hypothesis 3: If the Chairman of the Board of Statutory Auditors holds two or more roles in listed companies, the firm's financial reporting quality is lower.

Chapter 4: Research design: sample selection, variables and estimation method

The empirical analysis aims at testing the hypotheses developed: specifically, it examines the relationship between the number of roles held by the Board of Statutory Auditors' members in Italian listed companies with particular emphasis on those auditors appointed in more than one entity. The first part of this chapter is dedicated to the sample considered for the study and it includes a description of all the variables required for the analysis, as well as comments on the sample's values for these variables. The second part of the chapter introduces the estimation method that will be implemented in this study.

4.1 Sample selection

The analysis has been conducted by looking at Italian companies listed on the Milan Stock Exchange; in fact, boards' members of Italian listed corporations are obliged to communicate to CONSOB the number of positions held in other companies, both listed and not-listed. The search query considers Italian listed firms in the fiscal year 2018, to which a series of criteria has been applied for the extraction of the final sample. At the end of the 2018 fiscal year, 314 unique firms were listed on the Milan Stock Exchange. Financial institutions (insurance companies, banks, etc.) have been excluded from this sample because their Financial Statements differ significantly from those of companies operating in regular production and services sectors. Financial institutions produce untypical accounting record and have substantially different working capital structures (Klein, 2002). Furthermore, all entities whose historical data were missing have also not been considered. Last, the companies whose members of Board of Statutory Auditors were modified between fiscal years 2018 and 2020 have been excluded from the sample. The necessity of applying such criteria derives from the fact that CONSOB only publishes information on the current members of the Boards of Statutory Auditors, whose mandate lasts for three fiscal years.

The application of these selection criteria eventually led to a sample of 93 unique firms with an average market capitalization of € 2.63 billion. The final results of the sampling procedure are reported in Table 4.1

Table 4. 1

Sampling procedure and result

Research Criteria	Search Result
Italian listed Companies that are active in 2018	314
Elimination of financial companies	231
Incomplete data in Compustat	143
Inconsistent data on Board of Statutory Auditors	93
Final Sample	**93**

The data was collected from three different origins:

(1) Standard and Poor's Compustat database, to access Annual Financial Statements;

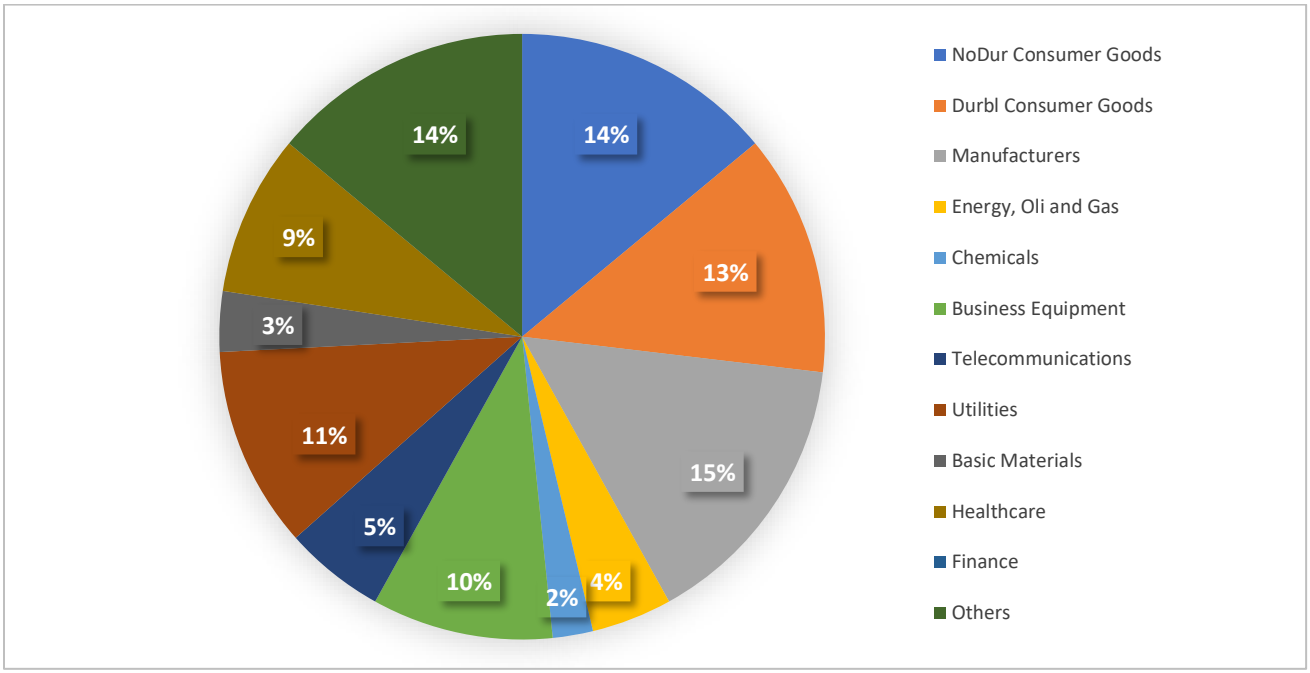
(2) firms' annual reports on corporate governance and ownership structure, to manually collect information on the number of roles held by each member of the Board of Statutory Auditors;

(3) CONSOB website, to retrieve the number of roles that Statutory Auditors hold in other public firms.

The pie chart in the next page, illustrates a summary of the industry of all the firms included in the sample. For each firm, the corresponding sector has been categorized by translating each SIC code (Standard Industrial Classification) into the twelve industries classified by Fama and French. The sample clearly represent the whole industry classification provided by the Milan Stock Exchange. The only industry not represented in the sample is the one of financial firms, due to the constrains that have been made in the selection of the sample. The most represented industries in the sample are: manufacturers, durable consumer goods and non-durable consumers good.

Figure 4.2:

Sample Firms' Industry



4.2 Variables measurement

4.2.1 Measures of earnings quality

In this model, earnings quality is considered a proxy of financial reporting quality of the firms included in the sample. Previous studies have identified numerous features of earnings quality, among which accruals, smoothness, investor responsiveness, restatements (Dechow and Schrand, 2004). However, prior literature does not suggest that there is a unique best proxy for earnings quality (Perotti and Wagenhofer, 2014). The next part of this chapter analyzes the proxies for earnings quality adopted in previous studies and then illustrates all the variables implemented in this model.

Proxies of earnings quality

Earnings persistence

Dechow et al. (2010) refers to earnings persistence as the ability of a firm to maintain a certain level of profits over time, which constitutes a clear indicator of income quality. Moreover, such property appears to be particularly useful for company valuation. In fact, if an enterprise shows persistent earnings, then its current profit is a very reliable predictor of future performance.
A common specification of earnings persistence is described as follows:

$$Earnings_{t+1} = \alpha + \beta\, Earnings_t + \varepsilon_t$$

where β measures persistence.

The positive relation implies that more persistent earnings are associated with higher earnings quality. Research has shown that the main determinant of this property is accruals, defined as the difference between profits and the Statement of Cash Flows' result. Indeed, earnings are more persistent when they consist predominantly of cash flows, rather than accruals. Other studies demonstrated that also easily readable financial reports and strong management guidance are correlated with higher persistence of earnings.
Therefore, persistence represents a positive signal of earnings quality, as it provides a reliable estimate of future cash flows, which constitutes a necessary input for company valuation.

Abnormal accruals

Accounting accruals are revenues earned or expenses incurred for which cash has not yet changed hands. These adjustments are usually made before Financial Statements are issued and they have an impact on a company's net profit, by affecting both its Balance Sheet and Income Statement. While "normal accruals" are required to properly represent a firm's performance within a specific year, "abnormal accruals" refer to unusual or discretionary accruals booked with the intention of manipulating earnings. Therefore, they are an important element to consider when measuring

earnings quality. Many models have been developed to identify those accruals that constitute a distortion of financial reporting and the most used are reported in Table 4.3.

Table 4.3

Accruals models

Accruals Model	
Jones (1991)	$Acc_t = \alpha + \beta_1 \Delta Rev_t + \beta_2 PPE_t + \varepsilon_t$
Modified Jones (Dechow et al., 1995)	$Acc_t = \alpha + \beta_1(\Delta Rev_t - \Delta Rec_t) + \beta_2 PPE_t + \varepsilon_t$
Performance matched (Kothari et al., 2005)	$DisAcc_t$ – *Matched firm's* $DisAcc_t$
Dechow and Dichev (2002) approach	$\Delta WC = \alpha + \beta_1 \Delta CFO_{t-1} + \beta_{2CFOt} + \varepsilon_t$
Discretionary estimation errors (Francis et al., 2005)	$TCA_t = \alpha + \beta_1 \Delta CFO_{t-1} + \beta_2 CFO_t + \beta_3 CFO_{t+1} + \beta_4 \Delta Rev_t + \beta_5 PPE_t + \varepsilon_t$ $\sigma = \alpha + \lambda Size_t + \lambda_2 \sigma(CFO)_t + \lambda_3 \sigma(Rev)_t + \lambda_4 log(OperCycle)_t + \lambda_5 NegEarn_t + \nu_t$

Abnormal accruals are estimated as the residuals from these regression models. Jones (1991) describes the accrual process as a function of sales growth and investment in Property, Plant and Equipment, commonly considered as drivers of a company's value. Dechow et al. (1995) proposed a modification of Jones' model, by taking into consideration growth in credit sales. Kothari et al. (2005) introduced a further improvement to the Jones' regression, by adding an independent variable to control for performance. This model compares a firm's abnormal accruals with those of a company in the same industry sector and same year with a similar Return On Assets. Dechow and Dichev (2002) approached the topic from a different perspective: they defined accruals as a function of cash flows (past, current and future), because accruals are booked to account for future payments and cash collections. They found a correlation between smaller, weaker firms and lower accrual quality. Francis et al. (2005) reviewed Dechow and Dichev's regression by including

revenue growth and Property, Plant and Equipment in order to control for performance and depreciation respectively.

Researchers have also analyzed the existence of a relation between abnormal accruals and earnings persistence, obtaining some interesting findings. For example, large accruals usually require more forecasts, which are likely to be reversed in future periods, generating a discontinuity in earnings. Regardless of this correlation, it is evident that accruals play an important role in determining the reliability of financial reporting.

Earnings smoothness

Earnings smoothing refers to lowering the fluctuations in firms' earnings. Researchers recognized that earnings smoothness makes earnings more informative about performance than cash flows. One question that the literature addresses is whether smoothness could be considered as an indicator of quality. Most of the studies supporting this concept are those that used cross-country data and analyzed the change in the consequences of country-level instead of firm-level measures of smoothness. However, the relation between smoothness and earnings quality remains arguable, as there is no common conclusion on whether earnings smoothness could be considered as indication of quality.

Asymmetric timeliness and timely loss recognition

Timely recognition of earnings is another measure that has been associated to earnings quality. Asymmetric timeliness is a property of accounting earnings that recognizes good news on a less timely basis than bad news. The model introduced by Basu (1997) it is the most frequently used to measure timely loss recognition from the following reverse earnings-return regression:

$$Earnings_{t+1} = \alpha_0 + \alpha_1 D_t + \beta_0 Ret_t + \beta_1 D_t * Ret_t + \varepsilon_t$$
$$D_t = 1 \; if \; Ret_t < 0$$

This model presumes that losses in returns (*Ret*) are efficiently reflected by the markets when such losses are incurred.

Basu (1997) provides also a second measure of timely loss recognition, which is not based on returns:

$$\Delta NI_t = \alpha_0 + \alpha_1 NEGDUM_{t-1} + \alpha_2 \Delta NI_{t-1} + \alpha_3 (NEGDUM_{t-1} * \Delta NI_{t-1}) + \varepsilon_t$$

where $NEGDUM_{t-1}$ is a dummy variable equal to one if $\alpha_2 \Delta NI_{t-1}$ is negative.

Loss recognition is timelier for firms that use International Accounting Standards (Barth et al. 2008) and in common law rather than code law countries (Ball et al. 2000). Overall, timely loss recognition is positively related to investor protection and it is higher only for firms audited by the so-called Big-Four audit firms (Garcia Lara et al. 2009).

Target beating

Target beating of earnings, also referred to as benchmarking, consists in analyzing small positive differences between reported earnings and any benchmark as a measure of earnings quality. Hayn (1995) and Burgstahler and Dichev (1997) have documented a "kink" in the distribution of reported earnings around zero. According to their findings, earnings measures, such as small profits and small loss avoidance, have been recognized as an indication of earnings management. However, there are still some contradictory evidence that provides several important caveats to this general conclusion (Dechow et al. 2010).

Earnings quality measures

As explained before, there is no unanimous agreement in earnings quality measures. In this study, two distinct metrics from the literature have been deployed:

(i) Abnormal Working Capital Accruals, estimated using the DeFond and Park (2001) model, which is particularly suitable when the number of observations in the sample is limited, as in this case;

(ii) the Modified Jones Model (Dechow et al', 1995), which is the Jones model (1991) adjusted for growth in credit receivables.

DeFond and Park model

The first earnings quality metrics is Abnormal Working Capital Accruals (AWCA). The definition proposed by DeFond and Park (2001) is the following:

$$AWCA_{i,t} = WC_{i,t} - WC_{i,t-1} * (Rev_{i,t} / Rev_{i,t-1})$$

where $Rev_{i,t}$ is the revenues and $WC_{i,t}$ is the level of non-cash working capital observed in year t for firm I, scaled by the beginning total assets determined as follows:

$$WC_{i,t} = (CA_{i,t} - Cash_{i,t}) - (CL_{i,t} - D_{i,t})$$

where CA is current assets, Cash is cash and short-term investments, CL is current liabilities, and D is short-term debt. The second term of the first equation represents the predicted value of working capital, calculated as working capital in the previous year ($WC_{i,t-1}$) and adjusted for the change in sales.

Modified Jones model

The second measurement considered is the Modified Jones Model. Following the equation proposed by Dechow et al. (1995):

$$\frac{TA_{i,t}}{Assets_{i,t-1}} = \alpha_0 \frac{1}{Assets_{i,t-1}}) + \beta_1 \frac{(\Delta Rev_{i,t} - \Delta Rec_{i,t})}{Assets_{i,t-1}} + \beta_2 \frac{PPE_t}{Assets_{i,t-1}} + \varepsilon_t$$

TA_t = Total accruals in year t divided by total assets in year $t-1$,

ΔRev_t = Revenues in year t less revenues in year $t-1$,

ΔRec_t = Delta revenues in year t less delta net receivables in year $t-1$,

PPE_t = Gross property plant and equipment in year t,

$Assets_{t-1}$ = Total assets in year $t-1$,

α_1, β_2, and β_3 = Parameters to be estimated,

ε_t = Residuals in year t.

Total accruals are defined as follows:

$$TA_{i,t} = (\Delta CA_{i,t} - \Delta Cash_{i,t}) - (\Delta CL_{i,t} - \Delta DCL_{i,t}) - \Delta Dep_{i,t}$$

ΔCA_t = Change in current assets in year t,

$\Delta Cash$ = Change in cash and cash equivalents in year t,

ΔCL_t = Change in current liabilities in year t,

ΔDCL_t = Change in short-term debt included in current liabilities in year t,

Dep_t = Depreciation and amortization expense in year t.

The discretionary accruals are calculated by measuring the non-discretionary accruals as a portion of the total accruals in the Modified Jones model (1995). The residuals from the regression estimated in the first equation are used as proxy for discretionary accruals, while the regression excluding residuals represents non-discretionary accruals that can be computed as:

$$NDA_{i,t} = TA_{i,t} + Res_{i,t}$$

where $Res_{i,t}$ are the residuals estimated in the first equation.

In order to facilitate the interpretation of the results, both measures of financial reporting quality adopted in this study, the abnormal working capital accruals (DeFond and Park model, 2001) and the discretionary accruals (Modified Jones model, 1995), will be multiplied by -1. Tariverdi et al. (2012) provides evidence that earnings management through accruals decreases the quality of financial reporting.

4.2.2 Busyness and multiple memberships

The main idea of this thesis is based on the assumption that the busyness of Statutory Auditors affects financial reporting quality. The first measure taken into consideration because of its impact on earnings quality is the average number of roles held by the members of the Board of Statutory Auditors (*BUSYNESS*). Those numbers have been gathered manually from firms' reports on corporate governance and ownership structure for the fiscal year 2018 under the section dedicated to the Board of Statutory Auditors. The second and third variables identified to measure the busyness of the Board of Statutory Auditors look at the type of roles held by Statutory Auditors, by distinguishing between the roles held in other public or private firms. As previously mentioned, this classification was possible because the plurality of roles in listed firms must be communicated to CONSOB. The objective of the second variable (*BUSY_BSA*) is to measure the interaction effect between the variable *BUSYNESS* and the type of roles the members held. This dummy variable takes the values of:

(1) if two or more members of the Board of Statutory Auditors hold two or more roles in other publicly traded firms;
(0) otherwise.

The third variable used to measure the busyness of the Board of Statutory Auditors is the number of roles held in other listed firms by the Chairman of the Board (*BUSY_CHAIR*). The purpose is to measure the interaction effect between the variable *BUSYNESS* and the type of roles the Chairman of the Board holds. The dummy variable *BUSY_CHAIR* takes the values of:

(1) if the Chairman of the Board of Statutory Auditors holds two or more roles in other publicly traded firms;
(0) otherwise.

Evidence in literature supports the idea that the busyness and workload of Auditors does affect financial reporting quality. Tanyi et al. (2015) investigated how the number of Audit Committee Chairs' positions affects their ability to oversee a company's financial reporting process. They reported that firms with busy Audit Committee Chairs have significantly higher levels of abnormal accruals.

4.2.3 Control variables

A common drawback of this kind of studies relates to the unfeasibility to include all the relevant variables and theoretical links in the regression model. The effects of these elements have been taken into consideration with the inclusion of four control variables: firm size (*SIZE*), leverage (*LEV*), sales growth (*GROWTH*) and profitability (*ROA*).
The first control variable, *SIZE*, was calculated as the natural logarithm of total assets. Prior studies consistently include firm size as control variable while studying the effects on earnings quality (Badolato et al., 2014; Chen et al., 2011). It is argued that smaller firms are more likely to engage in earnings management activities and that larger firms have more developed internal control systems (Ali and Zhang, 2015). The second control variable is leverage (*LEV*) and it was estimated as total debt over total assets. Leverage is included in this kind of studies to ensure that outside factors related to debt, such as debt commitments, are minimized (Farouk and Hassan, 2014; Lin et al', 2006). Moreover, prior studies found that firm leverage and external financing are related to earnings management (Becker et al., 1998; DeAngelo et al., 1994). Following the model presented in Hamberg et al. (2011), *ROA* was included as a control variable to account for the performance of the firms in the sample. It was calculated as net income lagged by total assets. The last control variable in the model is *GROWTH*, which is the annual percentage change in revenues. Doukakis (2014) argues that high growth firms are more likely to engage in accrual-based earnings management.

4.2.4 Variables overview

All the variables and their proxies used in the model are summarized in Table 4.4.

Table 4.4

Variables overview

Label	Description	Measured as
Dependent		
AWCA	DeFond and Park	$AWCA_{i,t} = WC_{i,t} - WC_{i,t-1} * (Rev_{i,t} / Rev_{i,t-1})$
DACC	Modified Jones	$TA_{i,t} = \alpha_0 + \beta_1(\Delta Rev_{i,t} - \Delta Rec_{i,t}) + \beta_2 PPE_t + \varepsilon_t$
Independent		
BUSYNESS	Roles held	Average number of roles held by the member of the BSA
BUSY_BSA (0,1)	Roles held	Dummy variable equals to "1" if at least two members hold two or more roles in listed companies, "0" otherwise
BUSY_CHAIR (0,1)	Roles held	Dummy variable equals to "1" if the Chairman of the BSA holds two or more roles in listed companies, "0" otherwise
Controls		
SIZE	Firm size	Natural logarithm of total assets
GROWTH	Sales growth	Annual percentage change in revenue
LEV	Firm leverage	Ratio of total debt to total assets

ROA	Profitability	Return on assets calculated as net income lagged by total assets

4.3 Descriptive statistics

Descriptive statistics provides basic features of the sample data. The descriptive statistics of the dependent earnings management variables, independent busyness variables and control variables are all presented in Table 4.5.

Table 4.5

Descriptive statistics of the variables considered

	N	Mean	SD	Min	Median	Max
EM Metrics						
|AWCA|	93	0.04	0.04	0.00	0.02	0.26
|DACC|	93	0.04	0.04	0.00	0.03	0.23
AWCA	93	0.00	0.05	-0.24	0.00	0.26
DACC	93	-0.01	0.05	-0.16	-0.01	0.23
Independent Variables						
BUSYNESS	93	9	7	1	8	47
BUSY_BSA	93	0.28	0.45	0	0	1
BUSY_CHAIR	93	0.43	0.50	0	0	1
Control Variables						
SIZE	93	6.88	1.93	2.52	6.84	12.02

GROWTH	93	0.13	0.67	-0.56	0.06	6.31
LEV	93	0.61	0.15	0.22	0.61	0.92
ROA	93	0.05	0.06	-0.17	0.03	0.35

It is important to make some relevant considerations regarding the descriptive statistics represented in this table. The mean absolute value of accruals is 0.4% of total assets for both earnings management metrics calculated in this study. The mean of the variable *BUSYNESS* shows that the average number of roles held by Statutory Auditors per firm is 9. The variable *BUSY_BSA* indicates whether two or more members of a Board of Statutory Auditors hold two or more roles in other Italian listed companies. In this sample, the mean value indicates that 28% of the boards in the sample are composed by two or more members who hold roles in other listed firms, while the mean value of the variable *BUSY_CHAIR* demonstrates that 45% of the Boards' Chairmen hold two or more roles in other listed companies. The means of *LEV* and *GROWTH* are respectively 0.61 and 13%. The average *ROA* for the firms in the sample is 5%, which is commonly considered an adequate value.

4.4 Estimation method

Most previous researches applied regressions models to estimate the effects of one or more independent variables on earnings management (Lin and Hwang, 2010). The regression model generally had the following form:

$$EM_t = \beta_0 + \beta_1 X_{1,t} + \beta_2 X_{2,t} + \ldots + \varepsilon_{x,t}$$

where *EM* is a measure for financial reporting quality, *X* represents either an independent variable or a control variable, and *t* represents a point in time.

The aim of this research is to investigate the relationship between multiple directorships of Board of Statutory Auditors' members and financial reporting quality, where financial reporting quality is measured as proxy of earnings quality: abnormal accruals, estimated with DeFond and Park (2001) model, and discretionary accruals, estimated with the Modified Jones (1995) model. The

independent variable in the first hypothesis represents the average number of roles held by the firms' Board of Statutory Auditors' members, and the corresponding statistical analysis is performed by estimating the coefficients in the following regression model:

$$\textbf{H1}: EM_i = \alpha_0 + \beta_1 \boldsymbol{BUSYNESS_i} + \beta_2 SIZE_i + \beta_3 LEV_i + \beta_4 ROA_i + \beta_5 GROWTH_i + \varepsilon$$

where *EM* is measured as abnormal accruals and discretionary accruals. *BUSYNESS* is the average number of roles held by the members of the Board of Statutory Auditors. *SIZE* represents the natural log of the total assets at the end of the previous fiscal year. *LEV* is the ration between total debt and total assets. *ROA*, which is the annual return on assets, corresponds to net income divided by lagged total assets. *GROWTH* represents the annual percentage change in revenues.

The second and third hypotheses focus primarily on the interaction terms between the two independent variables included in the model. The first variable is *BUSYNESS*, which indicates the average number of roles held by the Board of Statutory Auditors' members in other firms. The second and third variables, respectively for the second and third hypothesis, are *BUSY_BSA* and *BUSY_CHAIR*, which are two dummy variables based on the multiple offices held only in publicly traded firms.

The regression models for the second and third hypotheses are:

$$\textbf{H2}: EM_i = \alpha_0 + \beta_1 BUSYNESS_i + \beta_2 BUSY\_BSA_i + \beta_3 (\boldsymbol{BUSYNESS_i} * \boldsymbol{BUSY\_BSA_i}) + \beta_4 SIZE_i + \beta_5 LEV_i + \beta_6 ROA_i + \beta_7 GROWTH_i + \varepsilon$$

and

$$\textbf{H3}: EM_i = \alpha_0 + \beta_1 BUSYNESS_i + \beta_2 BUSY\_CHAIR_i + \beta_3 (\boldsymbol{BUSYNESS_i} * \boldsymbol{BUSY\_CHAIR_i}) + \beta_4 SIZE_i + \beta_5 LEV_i + \beta_6 ROA_i + \beta_7 GROWTH_i + \varepsilon$$

where *EM* is measured as abnormal accruals and discretionary accruals. *BUSYNESS* is the average number of roles held by the members of the Board of Statutory Auditors. *BUSY_BSA* is a dummy

variable for multiple directorships in listed companies. *BUSY_CHAIR* is a dummy variable for chairmen's multiple directorships in listed companies. *SIZE* represents the natural log of the total assets at the end of the previous fiscal year. *LEV* is the ration between total debt and total assets. *ROA*, which is the annual return on assets, corresponds to net income divided by lagged total assets. *GROWTH* represents the annual percentage change in revenues.

It is interesting to analyze the interaction term between these variables because it is assumed that holding an office in a public company requires more time commitment than in a private entity. An interaction between two variables occurs when an independent variable has a different effect on the outcome depending on the values of another independent variable. Therefore, the interaction term shows whether a change in the second independent variable affects the result of the first independent variable. In this regression model, the interaction terms in the second and third hypotheses indicate whether holding two or more roles in listed companies only affects financial reporting quality.

Chapter 5: Presentation of the results and comments

The previous chapter described the sample selected for this study, the estimation model and all the variables selected; this chapter aims to present the results derived from the empirical analyses. The first part is dedicated to the results obtained from the three hypotheses, while the second part provides a summary of the results, its theoretical implications and limitations, and also some directions for future studies.

5.1 Hypotheses testing

The aim of this study is to analyze the relationship between multiple directorships of Board of Statutory Auditors' members and financial reporting quality. As mentioned in the last part of the third chapter, this research includes in total three different hypotheses. The first hypothesis investigates the relationship between multiple directorships of the Board of Statutory Auditors and financial reporting quality. The second and third hypotheses focus on the roles held in other listed companies only and their influence on the busyness of the Board of Statutory Auditors and financial reporting quality. The second one analyzes the effect of the Board of Statutory Auditors' members' multiple directorships in listed companies and financial reporting quality. The third hypothesis examines the effect of the Board of Statutory Auditors' Chairmen's multiple directorships on financial reporting quality.

5.1.1 H1: Busyness of Board of Statutory Auditors and financial reporting quality

The first hypothesis investigates the relationship between multiple directorships of the Board of Statutory Auditors and financial reporting quality. Following prior studies, the expectation is a negative relationship between the multiple directorships of the Board of Statutory Auditors' members and financial reporting quality, measured as proxies of earnings quality.

H1: The higher the number of roles held by members of the Board of Statutory Auditors, the lower the financial reporting quality of the audited firm.

The estimated regression model is the following:

$$EM_i = \alpha_0 + \beta_1 \boldsymbol{BUSYNESSi} + \beta_2 SIZE_i + \beta_3 LEV_i + \beta_4 ROA_i + \beta_5 GROWTH_i + \varepsilon_i$$

Table 4.1 shows the coefficients estimated from the regression of two measures of earnings quality (|*AWCA*|, and |*DACC*|) on multiple directorships of Board of Statutory Auditors' members (*BUSYNESS*) plus control variables for the listed firms in the sample and their respective p-values. Standard errors are reported in parenthesis.

Table 5.1

Empirical results for H1

Variables	**|AWCA|**	**|DACC|**
BUSYNESS	**-0.001****	**-0.001*****
	(0.001)	(0.001)
SIZE	0.004	0.004*
	(0.002)	(0.002)
ROA	0.079	0.087
	(0.068)	(0.063)
LEV	0.002	0.033
	(0.028)	(0.026)
GROWTH	-0.017**	-0.001
	(0.006)	(0.006)
# Observations	93	93

Adjusted R-square	10.80%	14.59%

*, **, *** indicate significance at the 10%, 5%, and 1% levels, respectively.

As expected, the results of the analysis show a negative relation between the busyness of the Board of Statutory Auditors' members (*BUSYNESS*) and the financial reporting quality for both earnings management metrics (*AWCA* and *DACC*), therefore indicating a negative relationship between multiple directorships and financial reporting quality (Wee Kheng Soon, 2011). Both results delivered through the DeFond and Park model (2001) and the Modified Jones model (1995) are statistically significant.

5.1.2 H2: The impact of holding multiple offices in publicly traded firms

The second hypothesis focuses on the roles held in other listed companies by the members of the Board of Statutory Auditors. It analyzes the effect of holding two or more roles in listed companies on the financial reporting quality of the audited firm. The objects of attention in this hypothesis are the interaction terms between the two independent variables included in the model, *BUSYNESS* and *BUSY_BSA*. The interaction terms help explaining the interactions between two or more independent variables. Again, the expectation is a negative relationship between multiple directorships in listed companies and financial reporting quality.

H2: If two or more members of the Board of Statutory Auditors hold two or more roles in listed company, the financial reporting quality is lower.

The estimated regression model is the following:

$$EM_i = \alpha_0 + \beta_1 BUSYNESS + \beta_2 BUSY\_BSA_i + \beta_3(\boldsymbol{BUSYNESS_i} * \boldsymbol{BUSY\_BSA_i}) + \beta_4 SIZE_i + \beta_5 LEV_i + \beta_6 ROA_i + \beta_7 GROWTH_i + \varepsilon_i$$

Table 4.1 shows the coefficients estimated from the regression on two measures of earnings quality (|*AWCA*|, and |*DACC*|) on multiple directorships of Board of Statutory Auditors' members (*BUSYNESS*) plus control variables for the listed firms in the sample and their respective p-values. Standard errors are reported in parenthesis.

Table 5.2

Empirical results for H2

Variables	**|AWCA|**	**|DACC|**
BUSYNESS	-0.001	-0.001*
	(0.001)	(0.001)
BUSY_BSA	-0.002	-0.001
	(0.018)	(0.017)
BUSYNESS*BUSY_BSA	**-0.003****	**-0.002**
	(0.002)	(0.001)
SIZE	0.006***	0.005**
	(0.002)	(0.002)
ROA	0.041	0.068
	(0.064)	(0.063)
LEV	0.006	0.035
	(0.026)	(0.025)
GROWTH	-0.016***	0.001
	(0.006)	(0.006)
# Observations	93	93
Adjusted R-square	24.49%	12.53%

*, **, *** indicate significance at the 10%, 5%, and 1% levels, respectively.

The results of the analysis show a negative relation between both measures of financial reporting quality and both *BUSYNESS* and *BUSY_BSA*. In addition, the interaction terms between the two independent variables included in the model, *BUSYNESS* and *BUSY_BSA*, are found to be positive, therefore suggesting that multiple directorships in listed companies have a negative effect on financial reporting quality. The result delivered through the DeFond and Park model (2001) is significant, while the result derived from the Modified Jones model (1995) is not significant.
It is not surprising that the first model provides significant result, because the adjusted R-square in H2 has substantially increased (24.49%) with respect to the adjusted R-square in H1 (10.80%), while in the second model it has slightly decreased (12.53% from 14.59%). Looking at the values of the adjusted R-square is very important, as an increase on its value means that the new terms included in the model improve the model fit more than would be expected by chance. Also, the coefficient of determination, R-square, is the measure of goodness of fit most extensively used in regression models (Kvalseth, 1985).

5.1.3 H3: The impact of the Chairmen's multiple directorships in publicly traded firms

The third hypothesis focuses on the roles held in other listed companies by the Chairmen of the Board of Statutory Auditors. It analyzes the effect of holding two or more roles in listed companies on the financial reporting quality of the audited firm. The object of attention in this hypothesis is the interaction term between the two independent variables included in the model, BUSYNESS and BUSY_CHAIR. The expectation for the interaction term is to be negative, as it indicates that the effect of holding multiple directorships on financial reporting quality is higher when the Chairman holds two or more roles in listed companies.

H3: If the Chairman of the Board of Statutory Auditors holds two or more roles in listed company, the financial reporting quality is lower.

The estimated regression model is the following:

$$EM_i = \alpha_0 + \beta_1 BUSYNESS + \beta_2 BUSY\_CHAIR_i + \beta_3 (\boldsymbol{BUSYNESS_i * BUSY\_CHAIR_i}) + \beta_4 SIZE_i + \beta_5 LEV_i + \beta_6 ROA_i + \beta_7 GROWTH_i + \varepsilon_i$$

Table 4.1 shows the coefficients estimated from the regression on two measures of earnings quality (|*AWCA*|, and |*DACC*|) on multiple directorships of Board of Statutory Auditors' members (*BUSYNESS*) plus control variables for the listed firms in the sample and their respective p-values. Standard errors are reported in parenthesis.

Table 5.3

Empirical results for H3

Variables	**|AWCA|**	**|DACC|**
BUSYNESS	-0.001	-0.001
	(0.001)	(0.001)
BUSY_CHAIR	0.015	0.011
	(0.014)	(0.014)
BUSYNESS*BUSY_CHAIR	**-0.003****	**-0.002**
	(0.001)	(0.001)
SIZE	0.005**	0.004*
	(0.002)	(0.002)
ROA	0.096	0.095
	(0.065)	(0.063)
LEV	-0.004	0.030
	(0.027)	(0.026)
GROWTH	-0.017***	0.001
	(0.006)	(0.006)
# Observations	93	93

Adjusted R-square	**18.95%**	**10.74%**

*, **, *** indicate significance at the 10%, 5%, and 1% levels, respectively.

The results of the analysis show a negative relation between the absolute value of earnings quality and the busyness of the Board of Statutory Auditors' members (*BUSYNESS*). Also the relation between *BUSY_CHAIR* and financial reporting quality results to be negative, suggesting that if the Chairman of the Board holds two or more roles in listed companies, financial reporting quality is lower. The interaction term between the two independent variables (*BUSYNESS* and *BUSY_CHAIR*) in the model results to be negative, therefore suggesting that the effect of holding multiple directorships on financial reporting quality is higher when the Chairman holds two or more roles in listed companies. The result delivered through the DeFond and Park model (2001) is significant, while the result derived from the Modified Jones model (1995) is not significant.
Regarding the fitness of the models, also in H3, the first model is the one that provides significant results and where the adjusted R-square has substantially increased (18.95%) with respect to the adjusted R-square in H1 (10.80%), while in the second model it has slightly decreased (10.74% from 14.59%).

5.2 Summary of findings

This study examines the effect of Board of Statutory Auditors' busyness on financial reporting quality of Italian listed firms. The busyness of Board of Statutory Auditors' members is measured as the number of offices held in other companies, listed and not listed. Earnings management has been considered as metric for financial reporting quality, and it has been proxied by firms' abnormal working capital accruals calculated with DeFond and Park model (2001) and discretionary accruals estimated with the Modified Jones model (Dechow et al., 1995). This relationship is examined by drawing a sample of 93 entities listed on the Milan Stock Exchange in 2018. Consistent with prior literature (Lin and Hwang, 2010), a multiple linear regression model is employed using the ordinary least squares method.

The first hypothesis investigates the relationship between multiple directorships of the Board of Statutory Auditors' members and financial reporting quality and states that firms with busier Board of Statutory Auditors have lower financial reporting quality. Table 5.1 (p. 57) shows the results of the analysis. The expectation was proved to be correct. Both measures of earnings management (|*AWCA*| and |*DACC*|) show a significant positive relationship with the busyness of the Board of Statutory Auditors' members and suggest a negative impact on financial reporting quality, as a higher level of earnings management implies a lower financial reporting quality (Manzano and Conesa, 2014). These results are consistent with prior researches supporting the idea that multiple directorships affect the time commitment and the quality of the work (labor market theory).

The second and third hypotheses focus only on the roles held by the Board of Statutory Auditors' members in other listed companies. The second one analyzes the effect of holding two or more roles in listed companies and financial reporting quality. Table 5.2 (p. 59) shows the results of the analysis. The interaction term between the two independent variables in the model has been included in this second hypothesis and it is the center of the analysis. The results of the regression show a positive interaction term between the two independent variables included in the model: the average number of roles held by the members of the Board of Statutory Auditors *(BUSYNESS),* and the dummy variable which indicates if two or more members of the Board held two or more roles in listed company *(BUSY_BSA).* This result indicates that the effect of holding multiple directorships on financial reporting quality is higher when those roles are held also in listed companies. Both metrics of earnings management led to a positive coefficient; however, only the result with the abnormal working capital accruals proved to be significant.

The third and last hypothesis investigates the effect on financial reporting quality of Board of Statutory Auditors' Chairmen only, holding two or more offices in other listed companies. Table 5.3 (p. 61) shows the results of the analysis. Also in the third hypothesis, the interaction term has been included. The results of the regression show a positive interaction term between the two independent variables included in the model: the average number of roles held by the members of the Board of Statutory Auditors (*BUSYNESS*), and the dummy variable which indicates if the chairman of the Board held two or more roles in listed company(*BUSY_CHAIR*). This result indicates that the effect of holding multiple directorships on financial reporting quality is higher

when the Chairman holds two or more roles in listed companies. Both metrics of earnings management lead to a positive coefficient; however, only the results with the abnormal working capital accruals proved to be significant. These findings are consistent with other studies which analyzed only the Chairmen of the Audit Committees. Zheng (2008) did not find a positive relation between multiple directorships of the whole Audit Committee and financial reporting quality; however, he found a significant positive association between the multiple directorships of the Chairman and financial reporting quality.

5.3 Theoretical implications

This study provides valuable insights to the current available literature on multiple directorships and financial reporting quality, especially for the Italian context, where studies on the Board of Statutory Auditors appear to be scarce.

This research enriches the current literature in multiple ways.

First, by employing a country-specific context research for financial reporting quality and multiple directorships, this study contributes to the existing literature providing an analysis on the Italian environment only. As discussed in chapter two, prior literature provides numerous studies on the effect of characteristics and busyness of the Audit Committee's members and financial reporting quality. However, studies on the Italian firms' Board of Statutory Auditors are not easy to find.

Second, by employing different proxies of earnings management, it investigates the explanatory power of each specific measurement instrument considered in the models, DeFond and Park (2001) and Modified Jones (1995). The choice on the best proxies of earnings management has been widely discussed in the past and it is still at the center of current researches.

The final results show consistency with prior studies of various researchers. Dhaliwal et al. (2010) found that members of Audit Committees with higher directorships are associated with more earnings management. Moreover, Zheng (2008) reports a significant positive association between the multiple directorships of the Audit Committee's Chairmen and financial reporting quality.

5.4 Research limitations

Notwithstanding that the results of this research provide some valuable insights, it is important to address some of its caveats. Limitations in the study derive from the choice of the dependent variable and the controls variables included in the sample, as well as the limited size of the sample. First and foremost, the accuracy of the discretionary accrual models has been highly debated (i.e. Dechow et al., 1995 and Kothari et al., 2005), mainly because proxies of earnings management by abnormal working capital accruals or discretionary accruals remains an estimation. Despite the accuracy and reliability of the models being scientifically proven, results should always be treated with caution. Managers could engage in different earnings management practices rather than accruals-based earnings management (Doukakis, 2014). This study considers only accruals earnings management as measure of financial reporting quality and therefore may not be fully representative.

Second, the Italian context of this study limits the applicability of the results. As widely discussed in Chapter 1, the Board of Statutory Auditors is an internal control body present only in the Italian context. Therefore, even considering its similarity with the Audit Committee, the results of this study might not be applicable to the situation in other countries.

Third, the effect of the *SIZE* variable has been consistently significant, whilst other tested variables remain insignificant most of the time. This might indicate that this control variable distorts the rest of the analysis. However, the inclusion of firm size is consistent with many other prior studies and is hard to neglect and simply exclude from the research.

In addition to the three limitations exposed in this section, it is also relevant to consider that the choice of control variables might influences the results (Doukakis, 2014). Although numerous effects have been controlled for with control variables, there might be other incentives that affect financial reporting quality. For example, Klein (2002) and Cornett et al. (2009) discovered that there is a negative relation between board independence and financial reporting quality using abnormal accruals as a measure.

5.5 Directions for further research

The findings and limitations introduced several areas for future research. Although the findings do not prove to be significant with both earnings management proxies, the empirical results still provide for some implications about where future research can start from.

First, in this study, financial reporting quality has been considered to measure the quality of the supervisory work provided by the Board of Statutory Auditors' members. However, other researches could look at additional metrics to measures the effectiveness and the quality of their work in the audited firms.

Second, the earnings managements' proxies that have been considered in this study focused on the accrual-based earnings management: other proxies of real earnings management, such as timeliness, might have different results.

Third, the busyness of the Board of Statutory Auditors' members has been measured by simply counting the number of roles held by those members in listed and non-listed firms. As mentioned in Chapter 1, CONSOB regulates the limits on the cumulative positions held by the members of the internal control bodies, and sets the limit for the total number of administrative or control positions to be less or equal to six points resulting from the application of the calculation model showed in the Annex 5-bis (p. 35). If possible, it would be interesting to replicate a similar analysis using those scores as measure of the busyness of the Board of Statutory Auditors' members.

Finally, this research focuses on a relatively small sample including only listed firms. However, even though it is not mandatory to all private firms, the Board of Statutory Auditors' is required for some limited liability companies and it is optional for all other private companies. Future research could also include those entities in the sample and therefore amplify the sample size as well as diversify the firms in it.

Conclusion

A firm's Financial Statements, or Financial Report, represent an indispensable tool for managers in order to make the best business decision, as well for investors in order to evaluate their investment decisions. These two groups of users are not the only ones interested in the financial position of a certain firm: in fact, Financial Statements are one important source of information for various stakeholders, such as shareholders, banks and other lending companies, employees, suppliers, etc. An entity's Financial Report outlines its economic situation and its financial performances during that particular fiscal period, and having reliable, faithful and precise figures is one of the most important element required. The usefulness and precision of financial data are commonly referred to as the quality of the financial reporting (Downen, 2014).

Academic researches, in general, have always tried to investigate and analyze what can affect, both in a positive and negative way, the financial reporting quality. More specifically, academic studies often examine board members' characteristics and their relationships with the quality on the financial reports. It is very common that researchers do not agree unanimously on whether a certain characteristic of the board positively or negatively affects financial reporting quality. For example, one topic at the center of these discussions regards the busyness of the board members: while on one hand some studies show that a high level of busyness is associated with lower financial reporting because it reduces their effectiveness on performing their duties, on the other hand others argue that multiple directorships increase board members' knowledge, experience and ability, resulting in a higher level of quality on financial reports.

This study aimed to further investigate these relationships and it examined the relationships between the busyness of the Bord of Statutory Auditors' members and financial reporting quality by analyzing a sample of Italian publicly traded firms. The first chapter introduced the Italian corporate governance structures for joint stock companies (S.p.A.) and illustrated the role and the functions of the Board of Statutory Auditors, a characteristic internal control body of the traditional system. The second chapter summarized the concept financial reporting quality, by reviewing the financial reporting structure and the attributes of quality. The first part of the third chapter reviewed prior literature regarding the concept of multiple directorships at the board level. Then, after

providing an overview on the context of the analysis and the role of CONSOB, it introduced and discussed the hypotheses implemented in the study. The first hypothesis focused on the number of offices held by the Board of Statutory Auditors' members, while the second and the third hypotheses aimed to study the impact of holding multiple offices in other publicly traded companies. The forth chapter further explained the context of the study, by describing the sample and all the variables considered for the analyses. The last chapter presented the results of the regressions and offered some interesting insights to discuss about.

The first hypothesis, which investigated the relationship between multiple directorships of the Board of Statutory Auditors' members and financial reporting quality, showed that firms with busier Board of Statutory Auditors have lower financial reporting quality. In addition, the second and the third hypotheses, which focused on the effect of multiple directorships in listed companies and financial reporting quality, showed that holding two or more offices in other publicly traded companies increase the negative effect of busyness on financial reporting quality.

This study enriches the current literature in multiple ways. It further investigates the relationship between the busyness of the board members and the financial reporting quality and, at the same time, by applying a country-specific context research, it contributes to the literature on the Board of Statutory Auditors which seems hard to find. Also, by employing different measures of earnings management, it investigates the explanatory power of each specific metric. Nonetheless, this study presents also some limitations. There is no unanimous agreement among prior researches on which is the best measure for financial reporting quality, and neither on the best proxies for earnings management; therefore, as this study considers only accruals earnings management as measure of financial reporting quality, it may not be fully representative. Moreover, the Board of Statutory Auditors is an internal control body present only in the Italian context and, for this reason, the results of this study might not be applicable to the situation of other countries.

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